AREA STUDI MEDIOBANCA

PROGRESS IN TECHNOLOGY AND THE PANDEMIC ENCOURAGE THE DEVELOPMENT OF DIGITAL BANKS

Challenger banks are taking on the traditional banking system by providing services available exclusively via app and smartphone

Capital of €3.5bn was raised to support growth in 2021 (up 129.5% on 2020), plus another €1.8bn in 1H 2022

Twelve of the 96 European challenger banks are Italian: they are smaller than average in terms of size, but Italy is the best-represented country along with France after the United Kingdom, and reported 22.8% YoY growth in revenues for 2021

Milan, 14 July 2022

The Mediobanca Research Area has presented the second report in its planned series of research notes on the world of **FinTech** (the first, on PayTech companies, was published in December 2021). The new report is focused on the 96 European **challenger banks**, two-thirds of which are concentrated in three countries: 37 in the United Kingdom, 12 in Italy and 12 in France.

The full report is available for download from www.areastudimediobanca.com.

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Challenger banks and the banking system

The challenger banks, which often begin their lives as start-ups providing niche financial services, are digital banks focused on product innovation, with much lower operating costs and smaller in size than traditional banks. Their strong technology capabilities, coupled with the lack of physical branches and very low staffing levels, enable them to charge their customers lower costs, with basic product packages often free of charge, making them attractive to millennials in particular.

In the **last decade the European banking sector** has seen a structural downturn in revenues and margins, driven by flattening interest rates and the effects of the new regulations, further aggravated first by the pandemic and now the current geopolitical situation.
These challenges have forced the traditional banks to embark on a profound restructuring of their distribution models. **Bank staffing levels have seen major cuts between 2010 and 2020** (by 34.4% in Spain, 26.4% in the United Kingdom, 14.8% in Italy, and -13,9% in Germany), **and bank branch numbers have been cut even further** (by 48.3% in the United Kingdom, 48.1% in Spain, 36.8% in Germany, and 30.1% in Italy). The gap between Northern Europe and the Mediterranean bloc is particularly marked: whereas the former shows a low density of branches in relation to population, in the latter, the individual countries show ratios above the European average of 39 branches for every 100,000 adults: France has 61, Spain 57, and Italy 47.
The Northern European countries lead the way in terms of the **number of adult online banking services users**, with highs, as at year-end 2021, of above 90% in Norway, Denmark and Finland, and 86% in the United Kingdom. Italy here is lagging, with just 45%, below the European average (of 58%). This trend has accelerated during the pandemic, and is the

result of changes in customer preferences, with clients increasingly less loyal and more open to multi-channel banking (branches, internet, mobile phone and fixed line direct banking).
Access to bank branches also fell between 2008 and 2020, while the percentage of clients using the online channel to carry out banking transactions has continued to grow: in Italy some 67% of customers used this channel in 2020, up 7 p.p. on 2019, and up 40 p.p. on 2008.

The leading European challenger banks

A total of **96 challenger banks** in Europe have been identified. Of these, 63 have a full banking licence, 20 act as third-party operators, six have an IMEL or Payment Institution licence, while the remainder either have a banking licence with restrictions or are in the process of applying for one (i.e. they have begun the process but currently have limited operations). **Italy**, with its **12** challenger banks, is the best represented European country after the United Kingdom (37), on a par with France (12); Germany and Spain follow behind, with 8 and 7 challenger banks respectively. However, the Italian challenger banks are smaller, with below-average revenues and total assets.
Approx. 65% of the European companies analysed have been set up since 2013. The three-year period from 2014 to 2016 was the most productive, with 26 new companies launched.
Only nine of the challenger banks are listed on the stock market: six of them are UK banks, one Italian (Illimity Bank), one Estonian, and one Norwegian (Aprila Bank) which is traded on an un-regulated market (Euronext NOTC). Another three have been delisted, having been acquired by incumbents or investment funds.

In 2020 the European challenger banks' **revenues** increased by 3.9% versus 2019, while the aggregate bottom line deteriorated by 12.7%, in line with the performance of the Eurosystem banks in general. Aggregate ROE, which was already negative in 2019 (-5.1%), declined further by 0.4 p.p. to -5.5% in 2020. Conversely, both total assets and amounts due from customers increased year-on-year, by 11.4% and 4.9% respectively.
Revenues posted by **traditional banks** (i.e. challenger banks set up prior to 2010) shrank by 7.1%, showing the effects of the Covid-related restriction measures (this cluster includes some players with a lean physical presence to complement their online operations).
Conversely, the spread of the Covid-19 pandemic benefited the pure digital challenger banks, i.e. the **subsidiaries** (legal entities that manage large groups' online ventures) and **neobanks** (set up since 2010), with the former posting revenue growth of 19.9% and the latter of 24.8%. The neobanks, however, continue to reflect negative profitability levels, with ROE of -13.9% (up 0.1 p.p. on 2019). For them, reaching breakeven is linked to increasing customer base and expanding the range of services offered (which depends on them obtaining full banking licences). Such growth in size could prove to be a game-changer for them.
As for the **most recent trends**, at end-June 2022, only 34 operators had published their 2021 annual reports. While there has been a generalized increase in revenues, a high number of the neobanks are still reporting negative bottom lines.

Challenger banks and fund-raising

While the challenger banks' relationship with the stock market appears to be tenuous, their relations with the world of venture capital are more material. Since 2016 a total of €11.6bn in funding has been raised from this source; indeed, since **2021** a total of **€3.5bn** has been raised (up 129.5% on 2020). Estimates for **1H 2022** show funds raised up 82.3% on the same period last year, at €1.8bn, but growth appears to be slowing at least in part.
Access to funding is vital, not just to allow the challenger banks to shoulder the cost of the expensive process of obtaining authorization, but also to finance development of the business and increase market share.
The rising interest rate environment has made the fund-raising process more difficult and more costly. To take one example, Volt Bank, the first digital bank to obtain a banking licence in

Australia, was forced to close its doors at the end of June 2022, following several fruitless attempts to raise new capital.

Italian challenger banks

The Italian challenger banks came through the first year of the pandemic in outstanding fashion, delivering double-digit growth in both total revenues in 2020 (up 42.2% on 2019) and GOP (>100%), while the reduction in loan loss provisions (from €31.3m in 2019 to €10.3m in 2020) helped drive an improvement at the bottom-line level. In **2021**, higher provisioning slightly dampened the positive trend, which, however, remains impressive: **total revenues up 22.8% on 2020, and GOP up 75.2%**, with the net profit also improving by 63.1%. ROE too increased by almost 4 p.p., to reach 9.4% in 2021.
The performances at the balance-sheet level in 2020 were similarly impressive, with growth in amounts due from customers (up 38.8% on 2019) and aggregate total assets (up 35%). Again, there was a partial loss of momentum in 2021, although double-digit growth rates were once more recorded (customer receivables up 42.4% vs 2020 and total assets up 18.2%). The **workforce** also increased in size: up 18% in 2020 (vs 2019), and up 5.7% in 2021 (vs 2020).

The main **structural differences between the Italian challenger banks and credit institutions** involve the different percentage weights accounted for respectively by labour costs and general expenses out of total revenues: labour costs are lower for the challenger banks, but general expenses are higher. Further analysis of the latter item shows that consultancy, outsourcing and advertising costs are material in percentage terms: the downside of the lean staffing structures adopted by the challenger banks means they have to pay external operators for services that would otherwise be performed inhouse.

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